

## **DRAFT AMENDMENT**

### **ARIZONA INDIVIDUAL INCOME TAX RULING**

**ITR 04-\_\_\_\_**

(Supersedes Arizona Individual Income Tax Ruling ITR 02-1 and Arizona Guidelines  
For Exempt Securities G 91-4)

This substantive policy statement is advisory only. A substantive policy statement does not include internal procedural documents that only affect the internal procedures of the agency and does not impose additional requirements or penalties on regulated parties or include confidential information or rules made in accordance with the Arizona administrative procedure act. If you believe that this substantive policy statement does impose additional requirements or penalties on regulated parties you may petition the agency under Arizona Revised Statutes § 41-1033 for a review of the statement.

#### **ISSUE:**

Arizona individual income tax treatment of obligations of the United States Government, federal agencies, and United States Territories.

#### **APPLICABLE LAW:**

31 United States Code (U.S.C.) § 3124(a) prohibits all states from imposing an income tax on interest income from direct obligations of the United States Government.

Various U.S.C. sections prohibit state taxation of income from certain obligations of United States government sponsored enterprises and agencies and from certain obligations of United States Territories. See Appendix for specific code sections.

Arizona Revised Statutes (A.R.S.) § 43-961(5) disallows deductions when such deductions are allocable to a class of income that is not required to be included in the taxpayer's Arizona adjusted gross income or Arizona taxable income.

A.R.S. § 43-1022(6) provides a subtraction from Arizona gross income for interest income received on obligations of the United States. The amount subtracted must be reduced by any interest on indebtedness, or other related expenses, incurred to purchase or carry such obligations and deducted in arriving at Arizona gross income.

#### **LEGAL REFERENCES:**

*Rockford Life Insurance Company v. Illinois Department of Revenue*, 482 U.S. 182, 107 S. Ct. 2312 (1987), held that instruments commonly known as "Ginnie Maes" issued by private financial institutions and guaranteed by Government National Mortgage Association are not exempt from state taxation.

*Nebraska Department of Revenue v. Loewenstein*, 513 U.S. 123, 115 S. Ct. 557 (1994), held that 31 U.S.C. § 3124(a) does not prohibit states from taxing interest income derived from repurchase agreements involving United States government obligations.

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*Smith v. Davis*, 323 U.S. 111 (1944) sets forth the types of credit instrumentalities that are exempt under 31 USC § 3124(a).

### **DISCUSSION:**

#### **Interest Income From Exempt Obligations**

Federal law prohibits all states from imposing an income tax on interest income from direct obligations of the United States Government. Additionally, federal law may prohibit state taxation of interest income from the obligations of government-sponsored enterprises and agencies and from the obligations of United States Territories. Exempt interest income that is included in Arizona gross income (Federal adjusted gross income) may be subtracted in computing Arizona adjusted gross income. Part I of the Appendix which is attached to this ruling lists those obligations whose interest income is exempt from Arizona income tax.

#### **Deduction of Related Expenses**

Interest or other related expenses incurred to purchase or carry tax exempt obligations cannot be deducted. If such expenses are included in a taxpayer's Arizona gross income, the subtraction of exempt interest must be reduced by the amount of the expenses. If the taxpayer itemizes deductions on his or her Arizona return, the expenses must be excluded from the taxpayer's Arizona itemized deductions.

#### **Gain on Sale**

Any gain recognized for federal income tax purposes on the sale of United States bonds and notes or other tax exempt obligations is not considered to be interest on such obligations and is subject to Arizona income tax.

#### **Repurchase Agreements**

Interest from Repurchase Agreements involving United States government obligations is not exempt and is subject to Arizona income tax.

#### **Interest Income From Taxable Obligations**

There are a number of obligations that are issued under the authority of an act of Congress which are subject to Arizona income tax. These obligations may be guaranteed by the United States Treasury or supported by the issuing agency's right to borrow from the Treasury while other obligations may be backed by the pledge of full faith and credit of the United States Government. However, these obligations are not direct obligations of the United States Government to pay a specified sum at a specified

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date nor is the interest from these obligations specifically exempt from state taxation by the respective authorizing acts. Therefore, interest income from such obligations is subject to Arizona income tax. Part II of the Appendix lists some obligations that are subject to Arizona income tax.

### **RULING:**

Interest income received from the obligations listed in Part I of the Appendix which is attached to this ruling is exempt from Arizona income tax.

Interest or other related expenses incurred to purchase or carry tax exempt obligations cannot be deducted. If such expenses are included in a taxpayer's Arizona gross income, the subtraction of exempt interest must be reduced by the amount of the expenses. If the taxpayer itemizes deductions on the taxpayer's Arizona return, the expenses must be excluded from the taxpayer's Arizona itemized deductions.

Any gain recognized for federal income tax purposes on the sale of United States bonds and notes or other tax exempt obligations is subject to Arizona income tax.

Interest income received from repurchase agreements involving United States government obligations is subject to Arizona income tax.

Interest income received from the obligations listed in Part II of the Appendix is subject to Arizona income tax.

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J. Elliott Hibbs, Director

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Date

### Explanatory Notice

The purpose of a tax ruling is to provide interpretive guidance to the general public and to department personnel. A tax ruling is intended to encompass issues of law that are not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement that provides interpretation, detail, or supplementary information concerning application of the law. Relevant statute, case law, or administrative rules, as well as a subsequent ruling, may modify or negate any or all of the provisions of any tax

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ruling. See GTP 96-1 for more detailed information regarding documents issued by the  
Department of Revenue.

**APPENDIX  
TO  
ARIZONA GENERAL TAX RULING  
GTR 04-\_\_\_\_**

**PART I. TAX EXEMPT OBLIGATIONS**

**A. United States Government Obligations**

1. Interest from United States Treasury bonds, notes, bills, certificates, and savings bonds as set forth in 31 U.S.C. § 3124(a).

**Note:** Interest from zero coupon obligations issued by the United States Government ("STRIPS") is exempt from Arizona income tax. Interest from proprietary receipts ("CATS", "STARs", "TIGRs", "Cougars", "Lions", "Zebras", etc.) is also exempt.

2. Income from General Service Administration (GSA) Public Building Trust Participation Certificates as set forth in 31 U.S.C. § 3124(a).
  - (a) First Series, Series A through E.
  - (b) Second Series, Series F.
  - (c) Third Series, Series G.
  - (d) Fourth Series, Series H and I.

**B. Territorial Obligations**

1. American Samoa - Interest from industrial development bonds for Eastern Samoa issued by the Government of American Samoa as set forth in 48 U.S.C. § 1670.
2. Guam - Interest from bonds issued by the Government of Guam as set forth in 48 U.S.C. § 1423a.
3. Northern Mariana - Interest from bonds or other obligations issued by the Government of the Northern Mariana Islands as set forth in 48 U.S.C. § 1801 and § 607 of the Covenant to Establish a Commonwealth of the Northern Mariana Islands.
4. Puerto Rico - Interest from bonds issued by the Government of Puerto Rico as set forth in 48 U.S.C. § 745.

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5. Virgin Islands - Interest from bonds issued by the Government of the Virgin Islands as set forth in 48 U.S.C. § 1574(b)(ii)(A).

**Note:** Interest from the foregoing territorial obligations is not currently included in federal adjusted gross income. Therefore, this interest should not be subtracted from Arizona gross income in computing Arizona adjusted gross income. Since the interest is exempt from state income tax under federal law, it is not required to be added to Arizona gross income under A.R.S. § 43-1021(4).

#### **C. Federal Agency Obligations**

1. Banks for Cooperatives - Interest from notes, debentures, and other obligations issued by the Banks for Cooperatives as set forth in 12 U.S.C. § 2134.
2. Commodity Credit Corporation - Interest from bonds, notes, debentures, and other similar obligations issued by the Commodity Credit Corporation as set forth in 15 U.S.C. § 713a-5.
3. Farm Credit System Financial Assistance Corporation (Financial Assistance Corporation) - Interest from notes, bonds, debentures, and other obligations issued by the Financial Assistance Corporation as set forth in 12 U.S.C. § 2278b-10(b).
4. Federal Deposit Insurance Corporation - Interest from notes, debentures, bonds, or other such obligations issued by the Federal Deposit Insurance Corporation as set forth in 12 U.S.C. § 1825.
5. Federal Farm Credit Banks - Interest from consolidated system-wide notes, bonds, debentures, and other obligations issued jointly and severally under 12 U.S.C. § 2153 by Banks of the Federal Farm Credit System as set forth in 12 U.S.C. §§ 2023, 2098, and 2134.
6. Federal Financing Bank - Interest from obligations issued by the Federal Financing Bank as set forth in 12 U.S.C. § 2288 and 31 U.S.C. § 3124.
7. Federal Home Loan Banks - Interest from notes, debentures, bonds, and other obligations issued by Federal Home Loan Banks and from consolidated Federal Home Loan Bank bonds and debentures as set forth in 12 U.S.C. § 1433.
8. Federal Housing Authority - Interest from debentures issued by the Federal Housing Authority as set forth in 12 U.S.C. § 1710(e).

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9. Federal Land Bank Association - Interest from notes, debentures, bonds, and other obligations issued by the Federal Land Bank Association as set forth in 12 U.S.C. § 2098.
10. Federal Savings and Loan Insurance Corporation (FSLIC) - Interest from notes, bonds, debentures, and other obligations issued by the Federal Savings and Loan Insurance Corporation as set forth in former 12 U.S.C. § 1725(e).
11. Financing Corporation (FICO) - Interest from obligations issued by the Financing Corporation as set forth in 12 U.S.C. § 1441(e)(8).
12. General Insurance Fund
  - (a) General Insurance Fund of the Department of Housing and Urban Development as set forth in 12 U.S.C. § 1750c(d).
  - (b) Interest from debentures issued by the General Insurance Fund under the War Housing Insurance Law as set forth in 12 U.S.C. § 1739(d).
  - (c) Interest from debentures issued by the General Insurance Fund to acquire rental housing projects as set forth in 12 U.S.C. § 1713(l).
  - (d) Interest from Armed Services Housing Mortgage Insurance debentures issued by the General Insurance Fund as set forth in 12 U.S.C. § 1748b(f).
  - (e) Interest from National Defense Housing Insurance debentures issued by the General Insurance Fund as set forth in 12 U.S.C. § 1750c(d).
  - (f) Interest from Mutual Mortgage Insurance Fund debentures issued by the General Insurance Fund as set forth in 12 U.S.C. § 1710(d).
  - (g) Interest from debentures issued by the General Insurance Fund under the Neighborhood Conservation Housing Insurance Law as set forth in 12 U.S.C. § 1715K.
13. National Credit Union Administration Central Liquidity Facility - Interest from notes, bonds, debentures, and other obligations issued on behalf of the Central Liquidity Facility as set forth in 12 U.S.C. § 1795K(b).
14. Production Credit Association - Interest from notes, debentures, and other obligations issued by the Production Credit Association as set forth in 12 U.S.C. § 2077.

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15. Resolution Funding Corporation - Interest from obligations - Interest from obligations issued by the Resolution Funding Corporation as set forth in 12 U.S.C. § 1441b(f)(7)(A).
16. Student Loan Marketing Association - Interest from obligations issued by the Student Loan Marketing Association as set forth in 20 U.S.C. § 1087-2(h)(221).
17. Tennessee Valley Authority - Interest from bonds issued by the Tennessee Valley Authority as set forth in 16 U.S.C. § 831n-4(d).
18. United States Postal Service - Interest from obligations issued by the United States Postal Service as set forth in 39 U.S.C. § 2005(c)(4).

## **PART II. TAXABLE OBLIGATIONS**

### **A. Federal Agency Obligations**

1. College Construction Loan Insurance Association - Interest from obligations issued by the College Construction Loan Insurance Association as set forth in 20 U.S.C. § 1132.
2. Environmental Financing Authority - Interest from obligations issued by the Environmental Financing Authority as set forth in 33 U.S.C. § 1281.
3. Export - Import Bank of the United States - Interest from debentures issued by the Export - Import Bank as set forth in 12 U.S.C. § 635.
4. Farmers Home Administration - Interest from notes issued by the Farmers Home Administration as set forth in 7 U.S.C. §§ 1928 and 1929.
5. Federal Assets Financing Trust - Income from participation certificates issued by the Federal Assets Financing Trust as set forth in 12 U.S.C. § 1717(c).
6. Federal Financing Bank - Interest from bonds issued by the Federal Financing Bank as set forth in 12 U.S.C. § 2288.
7. Federal Home Loan Mortgage Corporation (Freddie Mac) - Interest from obligations issued by the Federal Home Loan Mortgage Corporation as set forth in 12 U.S.C. § 1455.
8. Federal National Mortgage Association (Fannie Mae) - Income from certificates issued by the Federal National Mortgage Association as set forth in 12 U.S.C. § 1718.

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### **(Continued)**

9. Federal Reserve Bank (FRB) – Income from dividends received by member banks of the Federal Reserve Bank as set forth in 12 USC § 289.
10. Government National Mortgage Association (Ginnie Mae) - Interest from bonds issued by the Government National Mortgage Association as set forth in 12 U.S.C. §§ 1720 and 1721.
11. Merchant Marine (Maritime Administration) - Interest from insured bonds as set forth in 46 U.S.C. § 1273.
12. Small Business Administration - Interest from notes issued by the Small Business Administration as set forth in 15 U.S.C. § 633.

#### **B. Obligations of International Institutions**

1. Asian Development Bank - Interest from bonds issued by the Asian Development Bank as set forth in 22 U.S.C. § 2901-9.
2. Inter-American Development Bank - Interest from bonds issued by the Inter-American Development Bank as set forth in 22 U.S.C. § 283.
3. International Bank for Reconstruction and Development (World Bank) - Interest from bonds issued by the World Bank as set forth in 22 U.S.C. § 286.

See Arizona Individual Income Tax Ruling ITR 02-2 for the Arizona income tax treatment of mutual fund dividends derived from interest on federal obligations.

See Arizona Individual Income Tax Ruling ITR 96-3 for the Arizona income tax treatment of pension plan distributions derived from interest on United States government obligations.

See Arizona Individual Income Tax Ruling ITR 96-2 for the Arizona income tax treatment of Individual Retirement Account (IRA) distributions derived from interest on United States government obligations.